Office of Aviation and International Affairs, Aviation Analysis

Southwest Expands to Philadelphia – Third Quarter 2004

Domestic Aviation Competition Issue Brief Number 26

Southwest's continuing focus on efficiency has enabled it to keep costs among the lowest in the industry. Southwest is one of the few airlines to have been profitable throughout the downturn that began in 2000 and has seen the U.S. airline industry as a whole lose more than $25 billion. 2004 marked Southwest's 32nd consecutive year of profitability.

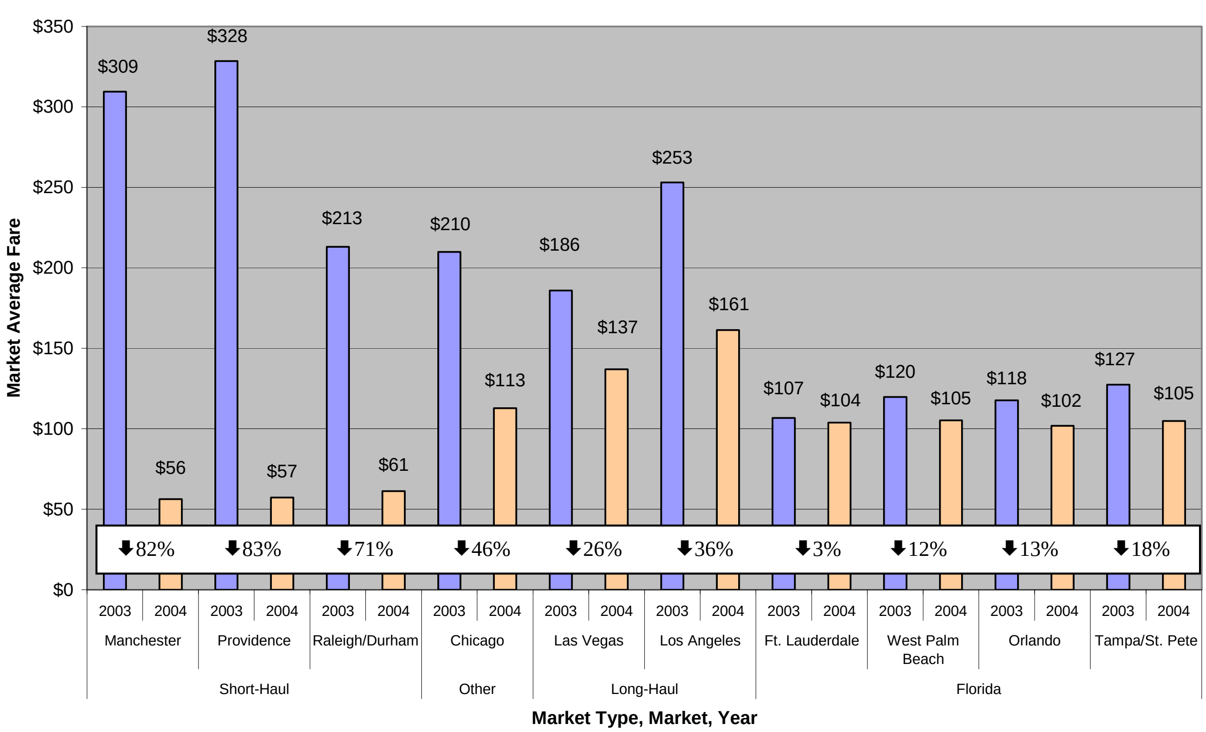
Southwest began service at Philadelphia on May 9, 2004 with 13 departures across six nonstop destinations. Since then, Southwest has rapidly expanded its presence in Philadelphia, both in terms of flights and number of nonstop destinations served. As of its February 2005 schedule, Southwest offered an average of 41 daily departures across 18 nonstop destinations. Southwest has indicated that it will continue to grow at Philadelphia. The airline has also announced that it will begin service at Pittsburgh in May 2005.

This report examines changes in fares and traffic between third quarter of 2004 (3Q04), the first full quarter of Southwest operations at Philadelphia, and the third quarter of 2003 (3Q03) in Southwest's Top 10 Philadelphia markets.

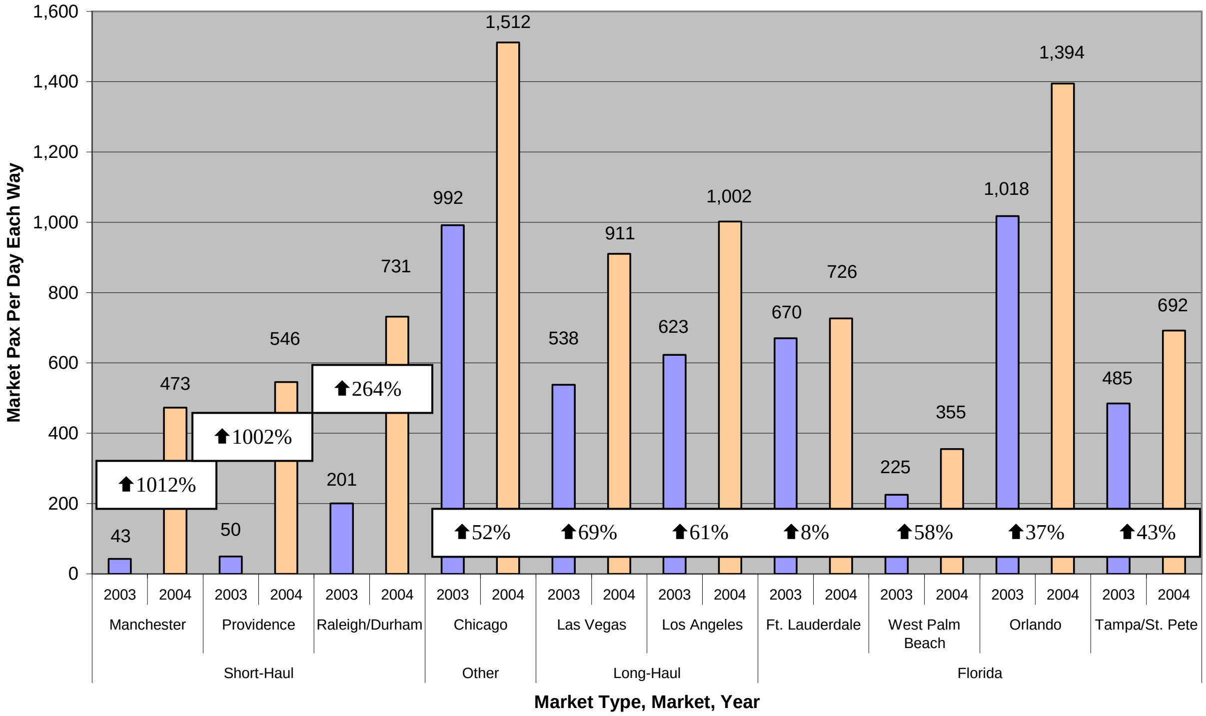
Fare and Traffic Impact

Graphs 1 and 2 below illustrate the year-over-year changes in market fares and passenger traffic per day each way (PDEW) in each of Southwest's Top 10 Philadelphia markets by volume, comparing 3Q03 (pre-Southwest entry) with 3Q04 (with Southwest in the market).

Graph 1: Average Market Fare in Southwest's Top 10 Philadelphia Markets By Volume
Pre-Southwest Entry (3Q03) vs. With Southwest (3Q04)



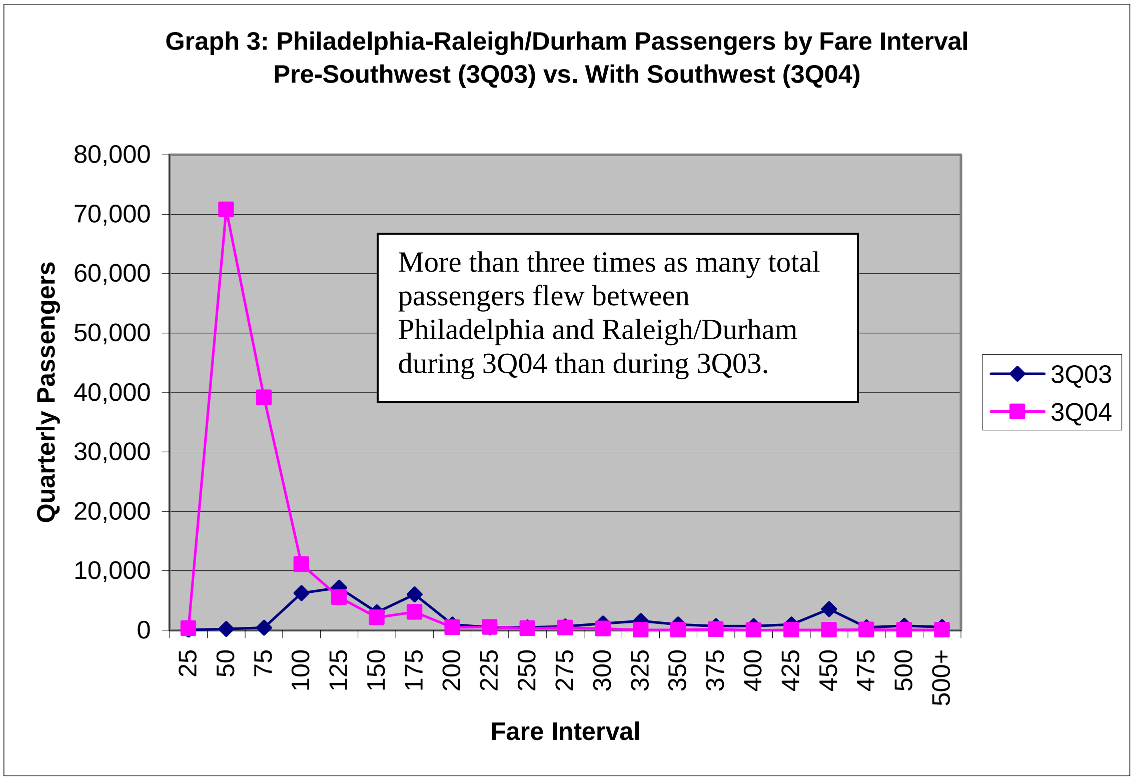
Graph 2: Average Market Passengers Per Day Each Way in Southwest's Top 10 Philadelphia Markets By Volume
Pre-Southwest Entry (3Q03) vs. With Southwest (3Q04)



Short-Haul Markets

The impact on fares and traffic has been most dramatic in Southwest's three largest Philadelphia short-haul markets. Average fares in the Manchester and Providence markets each fell by more than 80% while traffic increased to more than ten times the previous amount. In the Raleigh/Durham market, the average fare fell 71% and traffic more than tripled.

Graph 3 below provides further insight into the changes in the Philadelphia-Raleigh/Durham market. Graph 3 illustrates the distribution of traffic by $25 intervals in 3Q03 versus 3Q04. During 3Q03, a clear bimodal distribution existed, with the largest concentrations of traffic located at prices between $75 and $175 and between $425 and $450. This type of distribution is characteristic of markets where carriers are able to maintain pricing rules designed to segment the market into distinct higher fare business and lower fare leisure components, in order to take advantage of the difference between each segment's respective willingness to pay. However, after Southwest's entry, the existing carriers' ability to price discriminate in order to segment the market was greatly diminished. Both leisure and business travelers were able to take advantage of fares significantly lower than those that had previously been available.



The magnitude of the traffic increases in these markets once again illustrates the tremendous size of the market for low airline fares, even on short-haul routes where demand has been most affected since September 11, 2001.

Chicago and Long-Haul

The Chicago market is unique among the Top 10 because of the combination of its business orientation, medium-haul stage length, and multiple airport dynamic (Midway and O'Hare airports). During 3Q03, the Chicago-Philadelphia market was served nonstop by American, United, and US Airways at O'Hare and ATA at Midway. Despite the existing presence of four nonstop carriers in the market, including a low-fare carrier (ATA), after Southwest's entry, the overall Chicago (Midway and O'Hare)-Philadelphia average fare dropped by 46%, from $210 to $113, while traffic increased 52%.

The long-haul Las Vegas and Los Angeles markets experienced fare declines of 26% and 36% respectively. Las Vegas traffic increased 69% while Los Angeles traffic increased 61%. Prices and traffic in the Los Angeles market were affected not only by Southwest's entry, but also by the entry of Frontier, which offered new nonstop and connecting services in the market.[1]

Florida Markets

Florida markets are characterized by a different dynamic than most of the other markets in the Top 10. Florida markets are leisure oriented and therefore generally have lower prices than business oriented markets, all other things being equal. Fares in the Philadelphia-Fort Lauderdale, Orlando, Tampa/St. Petersburg, and West Palm Beach markets were already relatively low before Southwest's entry, in part due to the presence of AirTran which offers nonstop service in each of these markets except West Palm Beach and connecting service in all four. USA 3000 also entered the Philadelphia-Fort Lauderdale and Philadelphia-Tampa/St. Petersburg markets between 3Q03 and 3Q04.

[1] Frontier has announced that it will end its nonstop Philadelphia-Los Angeles service on February 23, 2005.

After Southwest's entry, the average fare declined in each of these four markets; however, the major impact of Southwest's entry in these markets was simply making additional capacity available to accommodate demand that was not being accommodated by the existing level of capacity in the market.

Summary

Southwest's entry has had a significant impact on prices and traffic levels at Philadelphia. As is customarily the case, Southwest's entry has had the most dramatic impact on short-haul markets where it offers many daily frequencies and charges fares that are a fraction of former levels. Table 1 below summarizes the changes in market average fares and passengers per day each way for each of Southwest's Top 10 Philadelphia markets.

Table 1: Average Market Fares and Passengers Per Day Each Way (PDEW) in Southwest's Top 10 Philadelphia City-Pair Markets By Volume 3Q03 (Pre-Southwest Entry) vs. 3Q04 (with Southwest)

Market	3Q03 Average Fare	3Q04 Average Fare	% Change in Average Fare	3Q03 PDEW	3Q04 PDEW	% Change in PDEW
Providence	$328	$57	**-83%**	50	546	**1002%**
Manchester	$309	$56	**-82%**	43	473	**1012%**
Raleigh/Durham	$213	$61	**-71%**	201	731	**264%**
Chicago	$210	$113	**-46%**	992	1,512	**52%**
Los Angeles	$253	$161	**-36%**	623	1,002	**61%**
Las Vegas	$186	$137	**-26%**	538	911	**69%**
Tampa/St. Petersburg	$127	$105	**-18%**	485	692	**43%**
Orlando	$118	$102	**-13%**	1,018	1,394	**37%**
West Palm Beach	$120	$105	**-12%**	225	355	**58%**
Ft. Lauderdale	$107	$104	**-3%**	670	726	**8%**

Although this report focuses on Southwest's Top 10 Philadelphia markets, Southwest's entry has had an impact on many other Philadelphia markets. Markets such as Oakland, St. Louis, Sacramento, Nashville, and San Diego, all of which Southwest served only on a direct or connecting basis during 3Q04, all experienced material declines in market average fares and corresponding increases in traffic.

In large part due to Southwest's entry, Philadelphia's overall fare premium relative to the domestic average declined from +20% during the 3Q03 to -2% during the 3Q04. This means that passengers traveling in Philadelphia markets now pay a bit less than the national average whereas one year prior they paid 20% more than the national average. Philadelphia fares should continue to decline as Southwest continues to grow its operations there.